Supreme Court, U.S.
FILED
DEC 13 1993
OFFICE OF THE CLERK

No. 93-569

In the Supreme Court of the United States

OCTOBER TERM, 1993

BERTHA PAGLIN FERMAN, EXECUTRIX OF THE ESTATE OF JULES J. PAGLIN, DECEASED, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES

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QUESTION PRESENTED

Whether curative legislation enacted in December 1987 retroactively to avert the potential abuse of an estate tax provision enacted in October 1986 violates due process when applied to transactions entered into by an estate in February 1987.

TABLE OF CONTENTS

	Page
Opinions below	1
Jurisdiction	1
Statement	2
Argument	8
Conclusion	9

TABLE OF AUTHORITIES

Cases:

Carlton v. *United States*, 972 F.2d 1051 (9th Cir. 1992), cert. granted, 114 S. Ct. 55	8, 9

Constitution and statutes:

U.S. Const. Amend. V (Due Process Clause)	6
Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203, § 10411 101 Stat. 1330	3
Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2106	2
Internal Revenue Code (26 U.S.C.):	
§ 2057	2, 3, 4, 6, 8, 9
§ 2057(b)(1) (Supp. IV 1986)	2
§ 2057(c)(1) (Supp. IV 1986)	2
Tax Reform Act of 1986, Pub. L. No. 99-514, § 1172(a), 100 Stat. 2085	2

Miscellaneous:

133 Cong. Rec. (1987):	
p. 4145	3
p. 4294	3
H.R. Rep. No. 391, 100th Cong., 1st Sess. Pt. II (1987)	4
I.R.S. Notice 87-13, 1987-1 C.B. 432	2-3, 4, 7

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-20a) is reported at 993 F.2d 485. The opinion of the district court (Pet. App. 1b-18b) is reported at 790 F. Supp. 656.

JURISDICTION

The judgment of the court of appeals was entered on June 18, 1993. A petition for rehearing was denied on July 15, 1993. The petition for a writ of certiorari was filed on October 12, 1993. The jurisdiction of this Court is invoked pursuant to 28 U.S.C. 1254(1).

STATEMENT

1. Petitioner is executrix of the estate of Jules J. Paglin, who died on October 27, 1986 (Pet. App. 6a). This case concerns whether decedent's estate is entitled to a deduction for estate tax purposes under Section 2057 of the Internal Revenue Code, 26 U.S.C. 2057.

a. Section 2057 was enacted on October 22, 1986, as part of the Tax Reform Act of 1986, Pub. L. No. 99-514, § 1172(a), 100 Stat. 2085. As originally enacted, Section 2057 allowed a deduction from the gross estate of fifty percent of the "qualified proceeds" of a "qualified sale" of any employer securities to an Employee Stock Ownership Plan (ESOP). The term "qualified sale" was defined as "any sale of employer securities by the executor of an estate to * * * an employee stock ownership plan" (26 U.S.C. 2057(b)(1) (Supp. IV 1986)). "Qualified proceeds" was defined as "the amount received by the estate from the sale of employer securities at any time before the date on which the return of the tax imposed by section 2001 is required to be filed." 26 U.S.C. 2057(c)(1) (Supp. IV 1986).[1] As originally enacted, Section 2057 did not explicitly require a decedent to have owned the securities in question to permit his estate to qualify for the deduction.

b. On January 5, 1987, the Internal Revenue Service issued a news release addressing a number of statutory changes affecting employee plans. The news release was formally published as Notice 87-13

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[1] Section 2057 has been repealed for estates of persons dying after July 12, 1989. See Omnibus Budget Reconciliation Act of 1989, Pub. L. No. 101-239, § 7304(a), 103 Stat. 2352-2354.

on January 25, 1987. 1987-1 C.B. 432. The Notice stated that "[p]ending the enactment of clarifying legislation," the IRS would not recognize the deduction permitted under Section 2057 unless the decedent "directly owned" the securities in question before death. 1987-1 C.B. at 442.

Legislation incorporating this decedent-ownership requirement was introduced in both houses of Congress on February 26, 1987. In introducing the 1987 amendment, Representative Rostenkowski, Chairman of the House Ways and Means Committee, noted that when Section 2057 was originally enacted in 1986, Congress anticipated that the resulting revenue loss would be approximately $300 million. 133 Cong. Rec. 4145 (1987). Shortly after the bill's passage, however, the Joint Committee estimated a possible revenue loss of as much as $7 billion—more than 20 times the amount originally anticipated—due to the fact that the statute did not explicitly limit the deduction to sales of securities owned by the decedent at death. The amendment proposed in 1987 embodied "an accurate statement of congressional intent in enacting the [original] provision." *Ibid.* Senator Bentsen, then Chairman of the Senate Finance Committee, observed that "Congress did not intend for estates to be able to claim the deduction by virtue of purchasing stock in the market and simply reselling the stock to an ESOP" (133 Cong. Rec. 4294 (1987)), for the provision had not been intended to permit a deduction for "essentially sham transactions" (*ibid.*).

c. On December 22, 1987, Congress enacted the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-185, 101 Stat. 1330. Section 10411 of that Act amended Section 2057 of the Internal Revenue Code

expressly to impose the requirement that the decedent own the stock at the time of death for the ESOP transaction to qualify for the estate tax deduction. That amendment was made effective as of the date of the original enactment of Section 2057 in October 1986. The Conference Report accompanying enactment of the 1987 amendment stated that, "[w]hile Congress intended to encourage transfers of employer securities to ESOPs by providing for partial elimination of estate tax liability, it was not intended that estates be able to eliminate all estate tax liability through use of the deduction." H.R. Rep. No. 391, 100th Cong., 1st Sess., Pt. II, at 1045 (1987). The Report concludes that "[t]he provision would not have been adopted in its [original] form had the full extent of the revenue impact and the effect of the provision been recognized" (*ibid.*). The Report explains that "[t]he modifications contained in the bill are designed to bring the revenue loss in line with the original estimate and Congressional intent" (*ibid.*).

2. Petitioner sought to obtain an estate tax deduction under Section 2057 by engaging in the following transactions: On February 20, 1987, after the promulgation of Notice 87-13, but before the curative legislation was introduced in Congress, petitioner purchased 12,300 shares of ALZA Corporation stock at a total cost of $348,960 on behalf of the decedent's estate. That same day, she entered into a Stock Purchase Agreement with the trustees of the ALZA Corporation Employee Stock Ownership Plan (ESOP) and sold the 12,300 shares to the ESOP for $329,175, or a discount of $17,325. Three days later, on February 23, 1987, petitioner purchased an additional

12,200[2] shares of ALZA stock for $329,090 and sold them to the trustees of the ALZA ESOP for $310,317.50, or a discount of $16,332.50. And, on February 24, 1987, petitioner purchased 11,200 shares of ALZA Corporation stock for $310,100 and sold them to the ALZA ESOP on that same day for $292,600, or a discount of $15,400. The total purchase price for the 35,700 shares of ALZA Corporation stock, including commissions, was $981,150.[3] The aggregate sales price of the stock to the ALZA Corporation ESOP was $932,092.50. These purchases resulted in an aggregate discount to the ESOP of $49,057.50 (Pet. App. 6a-7a, 5b).[4]

Petitioner entered into these transactions on the advice of her attorneys. The parties stipulated that her "decision to purchase these shares of ALZA stock, pay the commissions due on the purchases, and resell the stock to the ALZA ESOP at a discount, was purely tax motivated" (Pet. App. 7a). The parties further stipulated that "[t]he only reason that [petitioner] purchased ALZA stock, as opposed to the

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[2] A typographical error in the court of appeals' opinion describes this as a purchase of 112,200 shares (Pet. App. 6a). The district court's opinion correctly states that the purchases engaged in by petitioner in the three transactions were for a total of 35,700 shares (Pet. App. 5b).

[3] Petitioner executed these transactions with an account at Dean, Witter, Reynolds, Inc., in which she had deposited $350,000 (Pet. App. 5b). Since each stock purchase that she made amounted to less than $350,000, and since the stock was sold each time on the same day to the ALZA ESOP, petitioner needed no more than her initial $350,000 deposit to generate the $932,092.50 in aggregate sales proceeds.

[4] The record does not disclose whether the estate claimed this amount as a deduction on any fiduciary *income* tax return.

stock of another company, was the fact that the ALZA ESOP had by prior agreement agreed to purchase at a discount the entire quantity of ALZA Corporation stock directly from the estate, and the ALZA ESOP agreed to make the purchase from the estate over the three-day period" (*ibid.*). Petitioner also chose the ALZA ESOP because it had agreed to purchase the shares at a smaller discount than other ESOPs she contacted (*ibid.*).

3. On or about July 17, 1987, petitioner filed a timely federal estate tax return. No Section 2057 deduction was claimed on the return (Pet. App. 6b). On December 15, 1987, petitioner filed a claim for refund of $177,362.03 in federal estate taxes, plus interest. Petitioner asserted that the estate was entitled to a deduction under Section 2057 in the amount of $466,046.25, which was one-half of the $932,092.50 total sales proceeds received from sales of the ALZA Corporation stock to the ALZA Corporation ESOP. Petitioner calculated that the Section 2057 deduction reduced the taxable estate from $1,869,839.03 to $1,403,792.78, and that the estate's tax liability was thereby reduced from $511,097.55 to $333,735.52 (Pet. App. 8a).

4. When the IRS denied the claim for refund, petitioner commenced this refund suit in district court. Petitioner contended that the estate was entitled to the deduction under the provisions of Section 2057 as they existed at the time the sales were consummated. Petitioner contended that retroactive application of the 1987 amendments to Section 2057 violated the Due Process Clause of the Constitution (Pet. App. 8a).

The district court rejected petitioner's claim. At the outset, the court noted that there was "strong, indeed virtually unanimous, support for retroactive application of tax statutes" (Pet. App. 12b). The court rejected petitioner's argument that "she could not have foreseen Congress' retroactive amendment of section 2057 because no legislative action took place until after she completed the stock transfers at issue" (*id.* at 13b). In the district court's view, "Notice 87-13 forewarned what the future could and ultimately did bring" (*ibid.*):

> It would seem abundantly clear that, given the IRS' position, Congress would enact corrective and retroactive legislation at the earliest possible time.

The district court noted that, "[w]hile the net effect of the 1987 amendments to section 2057 clearly denied the * * * estate the benefits of the fifty percent deduction, such denial did not amount to a 'new tax' as contemplated by the relevant law" (*id.* at 14b). The court concluded that "Congress may surely correct any error or inadvertence it may have created" (*id.* at 17b).

5. The court of appeals affirmed. The court stated that "[e]valuating the government's retroactive amendment of section 2057 in the context of the facts before us, we conclude that the government did not inflict a 'harsh and oppressive' change in tax law upon [the] estate" (Pet. App. 15a). The court found it significant that Notice 87-13 was formally published "nearly a month *before* Ferman entered into the series of transactions at issue in this case" (*ibid.*). The court distinguished the Ninth Circuit's decision

in *Carlton* v. *United States*, 972 F.2d 1051 (1992), cert. granted, (1993), which had held application of the 1987 amendment to Section 2057 to a transaction engaged in by an estate in December 1986 to be unconstitutional. The court of appeals stated in the present case that, "although *Carlton* also involved an executor's reliance on section 2057, the executor in that case entered the transaction at issue nearly one month *before* the IRS issued Notice 87-13" (Pet. App. A15). The court concluded that, "[a]lthough Notice 87-13 did not carry the authority of binding law, it did notify taxpayers of the possibility that section 2057 would be amended, how section 2057 might be amended, and the fact that there was risk associated with entering into transactions solely out of reliance upon section 2057" (*id.* at A16).

ARGUMENT

On October 4, 1993, the Court granted certiorari to review the judgment in *Carlton* v. *United States*, No. 92-1241. In *Carlton*, the Ninth Circuit held the 1987 amendments to Section 2057 to be unconstitutional as applied to a transaction completed by an estate in December 1986. The court of appeals stated in *Carlton*, however, that "[w]e do not doubt the power of Congress to apply legislation retroactively to the time such legislation was introduced, or even to the time such legislation was proposed by the executive branch. * * * During this time period, the taxpayer is on notice that a change in law is forthcoming." 972 F.2d at 1062.

In the present case, by contrast with *Carlton*, the executor engaged in her stock transactions well after the Service had given public notice of its intent to

seek the curative change to Section 2057 that Congress enacted in December 1987. See pages 2-5, *supra*. In upholding application of the 1987 amendments to Section 2057 under the specific circumstances of this case, the court of appeals found it unnecessary to decide whether the estate tax deficiency would also be sustained under the circumstances that existed in *Carlton* (Pet. App. 15a-16a).

The decisions of the courts of appeals in these two cases are thus plainly not in direct conflict. Indeed, the Ninth Circuit in *Carlton* cited the decision of the district court in this case with seeming approval. 972 F.2d at 1062. Although the Court may wish to hold the petition in the present case pending its decision in *Carlton*, the two decisions do not conflict. Since the decision in the present case is correct, further review in this case is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied or should be held in abeyance pending this Court's decision in *Carlton* v. *United States*, No. 92-1941.

Respectfully submitted.

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DECEMBER 1993